Internal Revenue Service

memorandum

CC:INTL-903-87
Br1:WEWilliams

date: MAR 2 1988

to: District Director, Internal Revenue Service
Atlanta, GA
Attn: Chief, Examination Division (Matt Wallach)

from: Chief, Branch No. 1
Associate Chief Counsel (International) CC:INTL:1

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subject: [redacted]

This responds to your informal request for technical advice concerning an issue in this case.

ISSUE:

Whether the IRS may adjust the intercompany interest charged by [redacted] on its revolving loans to related domestic entities from [redacted]'s prime or [redacted] percent of [redacted]'s prime, as charged on the loans, to the safe harbor rate of 7 percent pursuant to I.R.C. § 482 and the Treasury Regulations thereunder. Alternatively, whether the facts will support a theory that [redacted] was a mere conduit and that the loans may be treated as having been made directly by [redacted]

FACTS:

On [redacted], [redacted], a [redacted] corporation hereinafter referred to as [redacted], formed a [redacted] Corp., [redacted], with a capital contribution of $[redacted]; on [redacted], [redacted]. formed a [redacted] corporation, [redacted], with a capital contribution of $[redacted]. On [redacted], [redacted] made a capital contribution to its wholly-owned [redacted] finance corporation, [redacted], which had been formed on [redacted], in the amount of $[redacted]. [redacted] had obtained the $[redacted] in a loan from the [redacted] on [redacted]. Immediately after this transaction [redacted] and [redacted], which had been formed to circumvent a [redacted] percent [redacted] capital tax on [redacted]'s capital contribution to [redacted], disappeared. On the same date ([redacted]), [redacted]'s [redacted] branch (hereinafter referred to as [redacted]), which had been established on [redacted], made revolving loans of approximately $[redacted] to [redacted], a U.S. corporation, and its consolidated subsidiaries. [redacted]'s sole purpose was the supervision of its [redacted] branch. The U.S. corporations used the funds to pay off loans they had obtained from unrelated parties in [redacted], to

finance acquisition programs, totaling $ and the balance of $ for corporate needs. On and , loaned an additional $ to the U.S. corporations.

In , issued shares of common stock for , generating net proceeds of , which were used to pay off the bank loans that had obtained to capitalize . For years through , 's loans to related parties in contrast to loans to unrelated parties were as follows at year end:

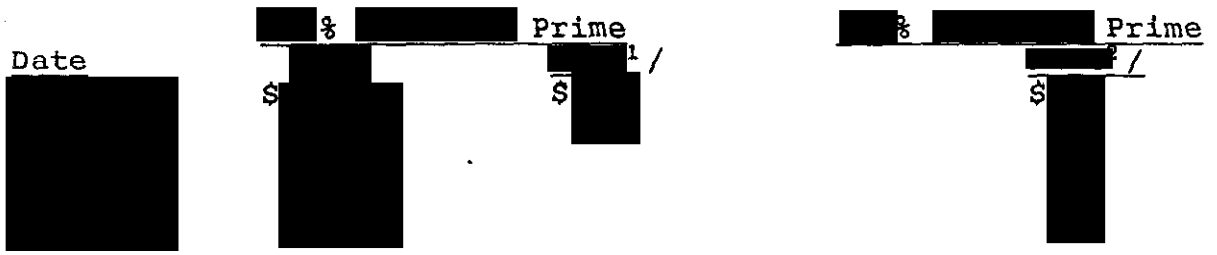
Year End	Related Loans	Unrelated Loans
	$	$

's sources of funds for making these loans were as follows:

Year End	Original Working Capital	Re-invested Earnings	Bank Loan	Bond Issue
	$	$	$	$

In , declared a dividend of $ which was paid to on . Additional dividends were paid by to in and in the respective amounts of $ and $.

During the years through , 's loans were primarily to three related U.S. corporations: , , and . The initial loans were made on , although actual loan agreements and promissory notes were not executed until after . The loan agreements for the initial loans contained the following provisions: and could borrow up to $ ($); and the and had the option to borrow, repay, or reborrow up to this limit for the period ending , at percent of 's prime rate; could borrow up to $ with the same terms except that the interest rate was 's prime rate. The loans to , , and were as follows, in millions:



Interest charged during the period through on loans to and ranged from to percent. The interest rates on these loans were allegedly based on statements from and on or about as to what they would charge the U.S. borrowing companies. also indicated that the companies could borrow at LIBOR plus to percent. LIBOR is an inter-bank interest rate offered in the Eurodollar or Eurocurrency market and is usually lower than the U.S. prime rate.

s structuring of the transactions in this manner rather than making loans or capital contributions directly to , , and resulted in substantial tax savings to the group. For the years through the U.S. subsidiaries paid interest to of approximately $. But for the - income tax treaty, these interest payments would have been subject to withholding and an effective tax rate of about percent. Under Article of this treaty, interest paid on indebtedness to a resident or corporation of one of the Contracting States is exempt from tax by the other Contracting State. There are two exceptions to this exemption. Under paragraph of Article , the exemption does not apply when the interest is attributable to a permanent establishment that the recipient of the interest maintains in the other Contracting State. Under paragraph , when the interest is paid to a related person, as defined in Article , and exceeds a reasonable and fair consideration for the indebtedness, the exemption applies only to the amount of the interest that represents a fair and reasonable consideration. s interest income was subject to a tax rate of approximately and percent.

1/ merged into in .

2/Includes loans to which merged with in .

3/Includes loans to which was a subsidiary of prior to its merger into and a division of after this merger.

In [redacted] and the [redacted] entered into an income tax convention. Article [redacted] of the [redacted] convention provided that dividends paid by a company resident in one state to a resident of the other state could be taxed only in the latter state, except that the former could withhold tax at a rate not exceeding [redacted] percent. There was also special provision, in paragraphs [redacted], and [redacted], for an increase in [redacted] withholding to equalize its taxation of distributed and undistributed profits, up to a maximum of [redacted] percent. The general rate of withholding tax, however, was reduced to [redacted] in certain circumstances. Specifically, no withholding tax could be applied in the case of a subsidiary company that had been wholly owned by its parent in the other jurisdiction during the [redacted] months preceding the day on which the dividend was paid or credited, provided that the subsidiary did not own shares of a company resident in the same state as the subsidiary at any time in the preceding [redacted] years, and provided that at least [redacted] percent of the subsidiary's gross income during the preceding three complete taxation years (or fewer if the subsidiary was more recently incorporated) was received in the form of dividends or interest from nonresidents [redacted].

For the years in question ([redacted]), the dividends paid by [redacted] to [redacted] presumably qualified for exemption from [redacted] withholding under Article [redacted] of the [redacted] convention. A new income tax convention between [redacted] and the [redacted] entered into force on [redacted]. The new treaty eliminates the [redacted] withholding rate on dividends. Article [redacted] of the treaty provides that dividends may be taxed by the country in which the payer is a resident: 1)up to [redacted] percent if the dividends are paid to a company that directly owns [redacted] percent of the capital of the payer; or 2)up to [redacted] percent in all other cases.

LAW:

You propose to reduce the interest rate charged on the loans from [redacted] to [redacted], [redacted], and [redacted] from [redacted] percent of prime or prime to [redacted] percent under the authority of I.R.C. § 482.

Specifically, section 1.482-2(a)(iii) of the Treasury Regulations provides that where one member of a group of controlled entities makes a loan or advance directly or indirectly to another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance. If a creditor is not regularly engaged in the business of making loans or advances of the same general type as the loan or advance in question to unrelated parties, the arm's length interest rate will be

determined on the basis of a safe harbor rate, unless the taxpayer establishes a more appropriate rate under an arm's length analysis. For loans and advances made prior to July 1, 1981 and after July 23, 1975, the arm's length interest rate was 7 percent simple interest, if the interest rate charged was less than 6 percent or more than 8 percent. See Treas. Reg. § 1.482-2(iii)(C). Section 1.482-2(a)(2)(i) of the Regulations defines "arm's length interest rate" as

> the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors will be considered, including the amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans.

Taxpayer attempts to establish that [redacted]'s prime or [redacted] percent of [redacted]s prime was an arm's length interest rate for the loans in issue on the basis of representations from [redacted] and [redacted] in [redacted] as to what these institutions would charge for the same loans. Apparently, an official of [redacted] stated that [redacted] could borrow in the market at [redacted] percent of prime and that [redacted] could borrow at [redacted] percent of prime. An official of [redacted] apparently represented that [redacted] could borrow at [redacted] to [redacted] percent of prime and that [redacted] would pay about [redacted] to [redacted] percent of prime. [redacted] charged [redacted] [redacted] percent of [redacted]'s prime and [redacted] [redacted] percent of [redacted]'s prime.

You argue that there are circumstances in this case that make the interest rates charged by [redacted] to [redacted] and to [redacted] unreasonable. Specifically, you contend that the quotes from [redacted] and [redacted] are not comparables, because [redacted] never intended to finance its U.S. subsidiaries' acquisitions through loans from unrelated parties. Rather, [redacted] raised the necessary funds through sales of stock at an approximate cost of [redacted] percent a year in dividends and generated interest deductions for the U.S. subsidiaries and nearly tax-free distributions from these subsidiaries to their [redacted] parent, [redacted], through the [redacted] intermediary entity. You also point out that the loans from [redacted] replaced loans that the U.S. subsidiaries had obtained from unrelated lenders, at terms of approximately [redacted] months, at the LIBOR interest rate. The LIBOR interest rate as compared to [redacted] percent of [redacted]'s prime rate was as follows:

Date	LIBOR	% of 's Prime

You also contend that the financing arrangement in issue distorted the incomes of and of the U.S. subsidiary/debtors and that this distortion indicates that the interest rates in question were excessive and not arm's length rates. In particular, you point out that from through , earned approximately representing a net profit of percent of gross revenues and a markup on costs of percent. In contrast, which was formed in incurred losses totaling about $ for the through period on revenues in excess of $ and assets of over $. You argue that these losses would have been substantially decreased if the interest rate on the loans from was percent rather than percent of 's prime.

Furthermore, you argue that the activities of in managing the loans to 's U.S. subsidiaries, cannot be considered an actual trade or business, that its activities were not comparable to those of a bank or lending institution, and that, therefore, s rate of return on the advances to the U.S. subsidiaries should be equivalent to the rate of return on cash investments rather than the interest rates prevailing on unrelated loans. You also argue that the structuring of the financing transaction was principally tax motivated, that there was no business purpose for the formation of , and that, therefore, the intercompany interest rate should be adjusted downward.

Whether taxpayer has established that the interest rate charged by to the U.S. subsidiaries was equivalent to an arm's length interest rate is essentially a factual issue. While there is little question that obtained a tax benefit from these transactions, this is not necessarily relevant to the arm's length interest rate question. The interest rates pegged to the prime rate that the officials of and apparently represented would be available to the U.S. subsidiaries in are not substantially different from the rates actually charged by . However, it is not clear that these representations were of arm's length rates prevailing at the situs of the lender

([redacted]) as required by section 1.482-2(a)(2)(i) of the Regulations.[4]/ In this regard, you may be able to establish evidence to support a theory that the LIBOR rates were the arm's length rates prevailing at the situs of the lender ([redacted]) and that interest paid by the U.S. subsidiaries in excess of the LIBOR rates was unreasonable.

While the loans from [redacted] were used to replace short-term loans (generally [redacted] months) to the U.S. subsidiaries from unrelated parties at the LIBOR interest rate and the loans from [redacted] were at higher interest rates, the loans from [redacted] were for revolving loans of up to $[redacted] for the period expiring on [redacted], and it is likely that a revolving loan for this extended period of time would bear a higher interest rate than the short-term LIBOR rate. Moreover, it is not altogether clear that the losses of the U.S. subsidiaries were attributable, directly or indirectly, to the interest paid on the loans to [redacted]. During the years in issue, [redacted] was attempting to penetrate an established U.S. market by acquiring existing and not always profitable U.S. companies. Therefore, we do not think that there is a definite connection between these losses and the interest rates that, on balance, do not appear to be that much out of line. Accordingly, it is our view that this case, to the extent that the interest rates do not exceed the prevailing interest rates at the situs of [redacted], would be difficult to defend on the theory that the interest rates charged by [redacted] were not arm's length. While some downward adjustment in the interest rates may be appropriate, we doubt that an adjustment to [redacted] percent could be defended.

Alternatively, you propose to apply conduit, treaty-shopping theories that would allow the IRS to treat the loans as having been made directly by [redacted] to its U.S. subsidiaries. You also would treat interest paid by the U.S. subsidiaries in excess of [redacted] percent as constructive dividends to [redacted]. For the reasons explained below, we do not believe that the IRS may make a conduit, treaty-shopping argument in this case.

The transactions in this case are somewhat similar to, although distinguishable from, those in Rev. Rul. 84-152, 1984-2 C.B. 381; and Rev. Rul. 84-153, 1984-2 C.B. 383. In Rev. Rul. 84-152, a Swiss corporation (P) owned 100 percent of a Netherlands-Antilles corporation (S) and 100 percent of the stock of a U.S. manufacturing corporation (R). P loaned a sum

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[4]/There is an exception to this situs rule in section 1.482-2(a)(2)(ii) of the Regulations for loans or advances the funds for which were obtained at the situs of the borrower.

of money to S which reloaned the same amount of money to R. R made timely interest payments to S which in turn made interest payments to P.

The facts in Rev. Rul. 84-153 are the same as those in Rev. Rul. 84-152, except that instead of P lending money to S, S raised an amount of money through a sale of bonds to foreign persons outside the U.S. S loaned the bond sale proceeds to R. R made timely interest payments to S which made timely interest payments to its bondholders.

The issue in both rulings was whether the exemption provided by [redacted] of the [redacted] Income Tax Convention, as extended to the [redacted], is applicable to the interest payments made by R to S. In both rulings, the IRS concluded that the exemption does not apply, because S was merely a conduit for the interest payments and never had complete dominion and control over the payments. The rulings conclude that S lacked sufficient business purpose to overcome the conduit nature of the transaction and that the payments would be considered interest to P in Rev. Rul. 84-152 and to the bondholders in Rev. Rul. 84-153.

It is our view that the circumstances of this case are distinguishable from those in the revenue rulings. Substantially all of [redacted]'s working capital was attributable to [redacted]'s equity contribution and to [redacted]'s reinvestment of its earnings, and none of the loans made by [redacted] are traceable to loans from [redacted] to [redacted] or to loans to [redacted] that were guaranteed by [redacted].

In any event, in Rev. Rul. 85-163, 1985-2 C.B. 349, the IRS announced that the holdings in Rev. Rul. 84-152 and Rev. Rul. 84-153 will not be applied to interest payments made in connection with debt obligations issued prior to October 15, 1984, and to interest payments made in connection with debt obligations issued on or after October 15, 1984, pursuant to a binding written agreement entered into prior to October 15, 1984. Because the debts in issue in this case as well as the years in issue are well prior to 1984, Rev. Rul. 85-163 prevents the IRS from attempting to apply Rev. Rul. 84-152 and Rev. Rul. 84-153 to this case.

In a memorandum dated April 8, 1987, to the Assistant Commissioner (International), the Associate Chief Counsel (International) set out guidelines for certain issues in the treaty shopping area. One area addressed in this memorandum is loan cases involving pre-October 15, 1984 debt. The memorandum states that while Treasury assumes that one effect of Rev. Rul. 85-163 is that the conduit/business purpose rationale of the 1984 revenue rulings will not be applied retroactively to situations that do not follow the general fact patterns of the

rulings, the National Office will support challenges to inbound financing arrangements under some circumstances. This is also true with respect to certain outbound situations. The memorandum gives as examples of situations where a challenge may be appropriate a case where the foreign finance subsidiary is thinly capitalized (i.e., a debt-to-equity ratio of 20:1 or greater) or where the corporate or transactional formalities have not been respected.

In this case, [redacted] was not thinly capitalized. Moreover, from all the evidence that we have available to us, it appears that all of the formalities were followed in organizing [redacted] in [redacted]'s contribution of capital to [redacted] and in [redacted]s loans to the U.S. subsidiaries. Accordingly, it appears that this case is unlikely to meet the requirements for a conduit/business purpose challenge under the guidelines set out in the Associate Chief Counsel's memorandum.

In Rev. Rul. 87-89, 1987-37 I.R.B. 16 the following three situations are described: 1) A foreign corporation, FP, is organized in country X that does not have an income tax treaty with the U.S. DS is FP's wholly-owned U.S. subsidiary. BK is an unrelated bank organized in country Z that does have an income tax convention with the U.S. under which interest paid by a U.S. person to a country Z resident is exempt from U.S. tax. In 1987, FP deposits 100x dollars in a demand deposit in BK which subsequently lends 80x dollars to DS. The difference between the interest rate that BK charges DS and the interest rate that BK pays on FP's deposit is less than one percentage point. 2) The facts are the same as in situation 1 except that BK is organized in country X, BK is not a bank, and FP's "deposit" is a long-term, short-term, or demand loan to BK. 3) DP, a U.S. operating, corporation owns all of the stock of FS, a country Y corporation. BK is an unrelated bank organized in country Y which has an income tax treaty with the U.S. under the terms of which interest paid by a U.S. person to a country Y resident is exempt from U.S. tax. In 1987, FS deposits 100x dollars in a demand deposit in BK which subsequently lends 80x dollars to DP. The difference between the interest rate that BK charges DP and the interest rate that BK pays on FS's deposit is less than one percentage point. In situations 1, 2, and 3, the interest rates charged by BK on the loans to DS and DP would have differed but for the deposits in BK by FP and FS.

The issue in each of the situations described in Rev. Rul. 87-89 is whether the deposit of funds with BK and the loan from BK are in substance a direct loan from FP to DS (in situations 1 and 2) or from FS to DP (in situation 3). The ruling concludes that if the loan from BK would have been made on the same terms irrespective of the deposit, the form of the transaction will be respected; otherwise, the transaction will be recharacterized as a direct loan because the deposit and

loan "are dependent transactions used as a device to disguise the substance of the transactions." The ruling concludes that in each of the three situations, the transactions will be treated as direct loans from FP in situations 1 and 2 and from FS in situation 3.

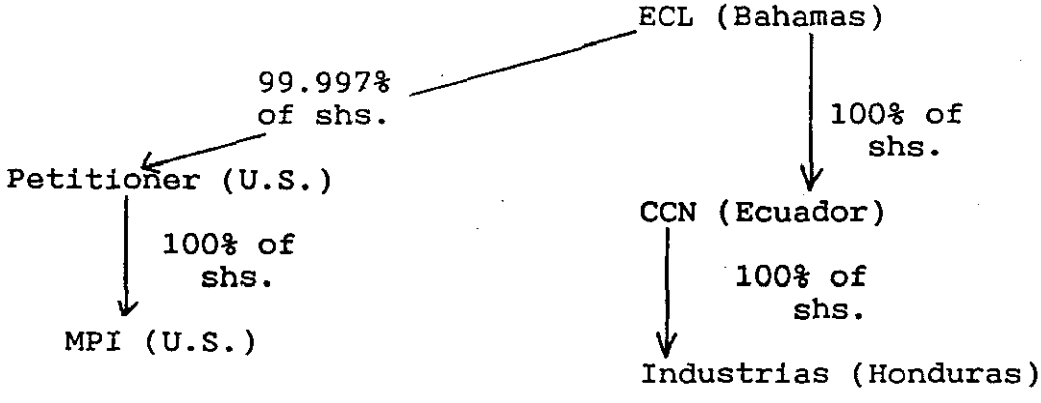
Rev. Rul. 87-89 relies in part on Rev. Rul. 76-192, 1976-1 C.B. 205. In Rev. Rul. 76-192, Y, a U.S. corporation, owns all of the stock of X, a controlled foreign corporation engaged in providing working capital for Y's U.S. business and abroad through its affiliates. To obtain funds, on January 1, 1971, X sold debt obligations to underwriters for offer and sale to the public outside the U.S. The proceeds were deposited by X in an unrelated, foreign financial institution. On January 31, 1971, Z, a foreign subsidiary of Y, borrowed from the same foreign financial institution at an arm's-length interest rate the same amount of money that X had deposited in the institution. Z loaned the proceeds to Y at an arm's-length interest rate. The loan to Z was guaranteed by Y, and X did not withdraw its deposit until Z repaid its loan. The difference in the rate of interest that the financial institution paid X on its deposit and the interest that the institution charged Z on its loan was less than one percent. The specific issue in the ruling is whether the loan by Z to Y was an investment by X in U.S. property within the meaning of I.R.C. § 956 (i.e., whether the loan to Y will be considered as having been made by X).

Rev. Rul. 76-192 concludes that under the facts Z was availed of by X principally for the purpose of holding Y's obligation, that Z held Y's obligation on X's behalf, and that all of the steps in the transaction from X's sale of debt obligations to Z's loan to Y were "undertaken as part of an overall plan to enable Y to obtain funds from its foreign subsidiaries." The ruling also concludes that the financial institution served as a mere conduit and that X's deposit in the financial institution will be treated as an investment of X's earnings in U.S. property to the extent that the amount of the loan to Y did not exceed X's earnings and profits available for distribution as a dividend.

It is our view that as with Rev. Ruls. 84-152 and 84-153, there are critical distinctions between this case and the circumstances in Rev. Ruls. 87-89 and 76-192. The major distinction is that the loans by [redacted] are attributable to funds received as capital contributions from [redacted] and corporate earnings and not attributable to loans to [redacted] from [redacted] or loans to [redacted] from unrelated entities and which loans were guaranteed by [redacted] It is possible that in some circumstances a capital contribution followed by an interest payment may be attacked under a conduit/business purpose rationale. For example, if a subsidiary makes a dividend payment that exactly matches its interest income, a conduit argument might

reasonably be made. However, it does not appear that the facts of this case would support such an argument. It is our view that this case is controlled by the audit guidelines set out in the Associate Chief Counsel's memorandum and that this case does not meet the requirements for a challenge under these guidelines.

An analysis similar to the one applied in the above revenue rulings was employed by the Tax Court in Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971). In Aiken, petitioner, a U.S. corporation with a principal place of business in New York owned all of the stock of MPI, also a U.S. corporation. A Bahamian corporation, ECL, owned 99.997 percent of petitioner's outstanding stock and all of the stock of CCN, an Ecuadorian corporation. CCN owned all of the stock of Industrias, a Honduran corporation. The ownership structure of these related corporations was as follows:



MPI borrowed $2.25 million from ECL on April 1, 1963, and MPI gave ECL a 4-percent sinking fund promissory note due in 1983. On March 31, 1964, ECL assigned MPI's note to Industrias in return for nine 4-percent promissory notes of Industrias, each in the amount of $250,000. Industrias had no office and carried on no business in the U.S.

During 1964 and 1965, Industrias' only income was interest income including $90,000 per year received from MPI on the 4-percent promissory notes. During these years, Industrias paid out substantially all of its income in interest to ECL. The assets of Industrias other than cash consisted of debt instruments of corporations owned by ECL. The income tax treaty between the U.S. and Honduras provided in Article IX that interest from a source in one of the Contracting States "received by" a resident of the other Contracting State that does not have a permanent establishment in the source State is exempt from tax in the source State. Under the authority of Article IX, MPI withheld no U.S. tax on the interest it paid to Industrias during 1964 and 1965. The treaty between the U.S. and Honduras was terminated on December 31, 1966, and MPI

repaid in full, on June 14, 1967, the $2.25 million in notes held by Industrias.

The issue before the Tax Court was whether the U.S. - Honduras tax treaty applied to the facts of this case so as to exempt from withholding MPI's interest payments to Industrias. The IRS took the position the interest should be treated as having been paid to ECL. The court, in holding for the IRS, concluded that the transactions with Industrias served no valid business or economic purpose and were structured in this manner to take advantage of Article IX of the treaty. Focusing on the words "received by" in Article IX, the court concluded, at page 933, that the phrase requires more than mere "physical possession on a temporary basis" and "contemplate[s] complete dominion and control." In short, the court concluded, at page 934, that "the petitioner ... failed to demonstrate that a substantive indebtedness existed between a United States corporation and a Honduran corporation" and that a tax avoidance motive while not absolutely fatal is not "standing by itself ... a business purpose which is sufficient to support a transaction for tax purposes. [Citations omitted.]" The court, in essence, treated Industrias as a "collection agent" for ECL and a mere conduit.

The Associate Chief Counsel's memorandum setting guidelines for the types of cases that will be defended involving pre-October 15, 1984 debt states that Chief Counsel will support challenges to arrangements "patterned after Aiken Industries." However, the guideline clearly indicates that the basis for the challenge is that the transfer of the debt instrument itself had no business purpose. Such a transfer did not occur in this case, and we could not argue under the facts of this case that [redacted]'s capital contribution to [redacted] served no business purpose.

CONCLUSIONS:

Without more direct evidence that the interest rates charged the U.S. subsidiaries by [redacted] were nonarm's length, we are not convinced that the IRS could successfully defend disallowance of the subsidiaries' deduction of interest paid to [redacted] in excess of the 7 percent safe-harbor rate. However, a case may be developed that the LIBOR rate was the prevailing arm's-length rate at the situs of the lender ([redacted]) and that interest paid by the U.S. subsidiaries in excess of the LIBOR rate was unreasonable.

With respect to the alternative conduit/treaty shopping theory, we think that Rev. Rul. 85-163 prevents the IRS from using this theory to defend treating the loans in this case as having been made to the U.S. subsidiaries directly by [redacted]. Furthermore, the facts of this case do not represent the abuses described in Aiken Industries and there is no evidence that the

lending subsidiary is thinly capitalized, and therefore, the prospective treatment provided in Rev. Rul. 85-163 requires that the conduit revenue rulings not be applied to this taxpayer.

This memorandum responds to your informal request for legal advice in this case and does not constitute a formal technical advice memorandum. Because it discusses matters in anticipation of litigation, a copy of this memorandum should not be furnished to the taxpayer.

MICHAEL F. PATTON